

## FEATURE ARTICLES

BACK ▲ PREVIOUS ◀ ▶ NEXT

### The Case for Retainage Reform: A "Win-Win" Proposal

#### *The One with the Gold Makes the Rules*

By: Don Gregory

And so it is with retainage—a word foreign to most dictionaries, but well-known to wall and ceiling subcontractors for its corrosive effect on the bottom line. For too long, the construction industry has tolerated withholding retainage far in excess of normal profit margins until well after work is satisfactorily performed.

Only the construction industry inflicts such a holdback on the party providing the goods or services. Who could imagine a car dealer standing by while you attempted to drive your new truck off the lot after paying only 90 percent of the purchase price? Yet that is precisely what many contractors and subcontractors have learned to tolerate.



This financing cost of retainage does not come without a price to those who pay their employees every Friday and their suppliers in 30 days. This hidden financing cost of retainage must be passed through to contractors and owners and ultimately reflected in project costs, or subcontractors will go out of business.

The American Subcontractors Association conducted a nationwide survey of 592 subcontractors from 39 states and determined that the average subcontractor was carrying \$620,025 in retainage receivables for an average of 160 days after the subcontractor had successfully completed his work. As these amounts generally exceed profit margins, the subcontractors are acting as a bank for the construction project. The significant financing costs associated with retainage are undeniable.

It is time to dispel the myths supporting retainage as we know it.

**Myth #1: Without retainage, subs will never finish their work.** The ASA survey found that only 17 percent of subcontractors believed that retainage was an effective tool in encouraging work completion. Such a conclusion is supported by common sense: Wouldn't a subcontractor be more likely to finish his work in exchange for final payment while his work force is still on site, rather than months after he has demobilized from the site? Wouldn't a subcontractor want to receive the final punchlist for the project while he is still working on the job site, rather than while he is working in earnest on another project?

Let us not forget that the true guarantee of satisfactory completion is a performance bond, and that no owner or contractor is obligated to make final payment until a subcontractor's work is satisfactorily completed. Reasonable amounts can be withheld, per item, for uncompleted punchlist items. Doesn't this make more sense than holding retainage on the excavating subcontractor who completed all his work months or years ago to ensure that the painter finishes his work?

For anyone who doubts the practicality of eliminating retainage, all they have to do is look to the federal government's experience. Since 1987, the federal government has held no retainage if satisfactory performance is being achieved, and reports no ill effects on the ability to get jobs

completed by subcontractors. Many state highway or transportation departments have followed the U.S. Department of Transportation's lead and also have eliminated retainage on highway projects with no ill effects. Elimination of retainage works—and the federal government has proven it.

**Myth #2: The owner needs the retainage money to finance the project.** A study commissioned by the Florida legislature admitted that, while it would be fairer to require any retainage to be repaid with interest, this would cost taxpayers money. (Instead, the study recommended the lien item release of retainage by trade.)

However, such a shortsighted approach ignores the fact that public owners and taxpayers are already paying for retainage in higher bids resulting in higher overall project costs. The ASA study found that if no retainage were held, 91 percent would be more likely to pursue that work; 69 percent would lower prices; and the average price reduction would be 3.1 percent.

Now, 3.1 percent of construction costs is a huge savings, to say nothing of the administrative costs associated in making often complicated retainage (or interest) calculations.

The lesson to be learned is that owners will get more and better bids if they eliminate retainage, resulting in lower overall project cost.

**Myth #3: Eliminating retainage or utilizing line item release requires tough judgment calls.**

In essence, owners and architects argue that institutional withholding of retainage "across the board" protects them from the consequences of their actions when making decisions about percent of completion and when a subcontractor's scope of work is completed. Without retainage or with line item release, these decisions have real consequences that cannot be masked with a pot of retainage money.

The federal government has declared that "retainage should not be used as a substitute for good contract management." Similarly, owner representatives should not abdicate their meaningful responsibilities to monitor project completion by figuring that "the retainage will cover it." The elimination of retainage and the close scrutiny of draws, including final payment, may well reduce the practice of "front end loading" and make certifications on draw requests actually mean something.

**Myth #4: The owner, contractor or bonding company needs the retainage in the event of a default.** This cynical approach was best characterized by a past president of ASA, Floyd Warkol, who stated, "The system is antiquated and begins with the premise that the contractor won't fulfill his obligations."

Hopefully, all of the retainage practices in the industry are not premised on the unlikely event of a contractor or subcontractor default. Even if they were, how fair is it to have the retainage earned by a performing subcontractor diverted to a bonding company, the IRS or another creditor to satisfy the obligations of a non-performing party?

And if the real purpose of retainage is to reduce the bonding company's risk in the event of a default, why is the amount of retainage increasing as the project progresses when the risk of a default is decreasing?

Bonding companies tell you that they base their premiums in large part on the risk they are required to assume. So if retainage is a meaningful factor in reducing their risk, why are premiums for performance bonds no more expensive on federal projects where there is no retainage than on projects with onerous retainage practices?

The bottom line remains that retainage is not a substitute for selecting good, qualified contractors, and subcontractors and requiring bonds when necessary.

So if traditional retainage practices are indeed obsolescent and in need of meaningful change, what are the options for reform short of the outright ban of retainage?

*Line Item Release.* A demolition contractor who had finished his work once told me that "the building is not coming back out of the ground." This demolition contractor should not have to wait months or years for the entire project to be finished to get his money. Line item release is fair and a great help to trades that finish their work early.

*Cap.* Withholding 8 percent or 10 percent retainage when net profit is considerably less forces contractors self-performing work and subcontractors to finance the job. A reduction of retainage to, for example, 5 percent, would help, and reducing or eliminating retainage on the second half of the project would help all but the early-finishing trades that favor line item release.

*No Retainage If Bond.* If a performance bond is in place, retainage is simply duplicative and unnecessary security for contract completion. An owner is already paying for the cost of the bond in project cost. The owner does not need to pay again through the hidden costs of retainage in the form of higher bids.

*Interest on Retainage.* An owner withholding retainage is using the contractor and subcontractor's monies previously earned and should pay for the privilege. Interest should be paid to both the general contractor and the subcontractor from an escrow account held in trust by the owner. In my home state of Ohio, when only interest is paid to the general contractor and not shared with the subs, the owner pays twice—interest to the general and in higher bid costs by the subs.

*No Greater Retainage Than Withheld on Contractor.* Once again, when the owner is holding less retainage on the general than the general is holding on the sub, these inequitable practices simply force the subcontractor to factor this financing cost into his bid to ensure financial survival. Project costs increase unnecessarily as a result.


New Mexico, Kentucky and Tennessee have joined the list of states recently implementing retainage reform.


The elimination or reform of retainage offers benefits for all of the parties acting as partners in the construction process. The owner should receive more and better bids. The contractor should receive his fee as it is earned. The subcontractor will no longer have to finance the project.


The challenge for supporters of retainage reform is to encourage others to recognize these benefits and not simply hold on to antiquated retainage practices because "we have always done it that way." Those holding on to such old-fashioned views may be doomed to be the dinosaurs of the construction industry of the new millennium.


*Don Gregory, director at Kegler, Brown, Hill & Ritter, Columbus, Ohio, is general counsel to AWCI. He can be reached at [dgregory@keglerbrown.com](mailto:dgregory@keglerbrown.com).*

---

 [print this page](#)

 [email to a colleague](#)

 [reply to the editor](#)

 [subscribe for updates](#)

---

**BACK** ▲ **PREVIOUS** ◀ ▶ **NEXT**